ORIGINAL OPEN MEETING ITEM

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ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
DOCKETED
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DATE: DECEMBER 4, 2007

DOCKET NO: WS-04235A-06-0303

TO ALL PARTIES:

Enclosed please find the recommendation of Administrative Law Judge Teena Wolfe. The recommendation has been filed in the form of an Opinion and Order on:

UTILITY SOURCE, L.L.C.
(RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

DECEMBER 13, 2007

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

DECEMBER 18, 2007 and DECEMBER 19, 2007

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Secretary's Office at (602) 542-3931.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

MIKE GLEASON - Chairman
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IN THE MATTER OF THE APPLICATON OF UTILITY SOURCE, L.L.C. FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PROPERTY AND FOR AN INCREASE IN ITS WATER AND WASTEWATER RATES AND CHARGES FOR UTILITY SERVICE.	DOCKET NO. WS-04235A-06-0303 DECISION NO. ____________ **OPINION AND ORDER**

DATES OF HEARING:	November 28, 2006 (Procedural Conference), April 13, 2007 (Prehearing Conference); June 19 and 20, 2007.
PUBLIC COMMENTS:	January 22, 2007[1] (Phoenix); March 19, 2007[2] (Flagstaff)
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Teena Wolfe
IN ATTENDANCE:	Mike Gleason, Chairman William A. Mundell, Commissioner Kristin K. Mayes, Commissioner Gary Pierce, Commissioner
APPEARANCES:	Mr. Richard L. Sallquist, SALLQUIST, DRUMMOND & O'CONNOR, on behalf of Utility Source; Mr. Starr Lamphere in pro persona; Mr. David Hitesman, in pro persona; Mr. Dennis Jones, in pro persona; and Mr. Charles Hains, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

[1] Assistant Chief Administrative Law Judge Dwight Nodes held the January 22, 2007, public comment session.
[2] The Commissioners held the March 19, 2007, public comment session.

BY THE COMMISSION:

On May 1, 2006, Utility Source, LLC ("Utility Source" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for water and wastewater utility service provided to customers in the Company's service area, located approximately eight miles west of Flagstaff, near Bellemont in Coconino County, Arizona.

Following the filing of additional information by the Company, the Commission's Utilities Division Staff ("Staff") found the application sufficient on July 3, 2006, and classified the Company as a Class C utility.

By Procedural Order issued July 10, 2006, a hearing in this matter was scheduled for January 22, 2007, and other procedural deadlines were established.

By Procedural Order issued December 20, 2006, the hearing date was continued to April 3, 2007, and the timeclock in this matter was extended accordingly.

Intervention was granted to Mr. Starr Lamphere, Mr. David Hitesman, and Mr. Dennis Jones.

On January 22, 2007, at the time and place noticed for the hearing, an opportunity for public comments was provided. The Company and Staff appeared through counsel. No members of the public appeared.

On March 19, 2007, a public comment hearing was held by Commissioners at the Coconino County Board of Supervisors Meeting Room in Flagstaff, Arizona. Members of the public attended, and several customers of the Company provided their comments on the application.

By Procedural Order issued on March 16, 2007, the hearing date was continued to May 1, 2007. Following the pre-hearing conference held on April 13, 2007, the hearing date was continued to May 2, 2007.

On April 27, 2007, the Company filed a Motion for Continuance due to unavailability of counsel. On April 30, 2007, a Procedural Order was issued continuing the hearing to June 19, 2007, and suspending the applicable timeclock during the continuance.

The hearing commenced as scheduled on June 19, 2007, before a duly authorized Administrative Law Judge of the Commission. The Company and Staff appeared through counsel and presented evidence. Intervenors Mr. Starr Lamphere, Mr. David Hitesman, and Mr. Dennis Jones appeared, each on his own behalf. Following the filing of post-hearing briefs by Utility Source, Staff, and Mr. David Hitesman, and other post-hearing filings, the matter was taken under advisement pending the issuance of a Recommended Opinion and Order for consideration by the Commission.

DISCUSSION

A. BACKGROUND

The Commission ordered Utility Source to file this rate application in Decision No. 67446 (January 4, 2005), which granted the Company its Certificate of Convenience and Necessity (CC&N) and set water and sewer rates. Utility Source began as a homeowners' association, controlled by the developer. The homeowners' association installed utility facilities, provided water and utility services, and established rates without first having obtained authority from the Commission to do so. Decision No. 67446 imposed a penalty of $20,000, and ordered that all the assets used in the provision of utility service be transferred to the Company. Decision No. 67446 found that increasing rates to a level commensurate with the Company's projected revenues, expenses, and number of customers at the end of five years of operations, as is customary with new CC&N applications, would result in an unconscionable increase for existing customers (Decision No. 67446 at 16, Findings of Fact No. 31). Decision No. 67446 also found that customers had not been provided notice in the CC&N proceeding that higher rates might result (*Id.* at 16, Findings of Fact No. 32). Decision No. 67446 therefore authorized the Company to continue charging the water and sewer rates that the homeowners' association had been charging, finding that "[t]he initial rates for Utility Source should therefore be set at the current level until an investigation can be undertaken in a full rate case to determine the cost of plant that is used and useful in the provision of service to customers, as well as an appropriate level of revenues and expenses" (Decision No. 67446 at 16, Findings of Fact. No. 32). While Decisions granting CC&Ns usually order the Company to file a rate case at the end of the first five year period of operations, Decision No. 67446 ordered the Company to file a rate application based on a 2005 test year within 17 months, due to the interim nature of the initial rates authorized by the Decision (Decision No. 67446 at 18, Findings of Fact No. 37).

Decision No. 67446 made specific findings regarding the rates illegally set by the developer of Flagstaff Meadows, the development that is served by Utility Source. The Decision stated that it appeared that the developer induced customers to purchase homes with water and wastewater rates insufficient to support the construction and long-term operations of water and wastewater systems for the planned development (Decision No. 67446 at 11, Findings of Fact No. 26). The Commission ordered the Company to notify its customers that the Company had commenced operations without Commission authorization, and that higher rates for customers would likely result in the future due to the Company's actions (*Id.* at 18, Findings of Fact No. 38). In compliance with the requirements of Decision No. 67446, on February 2, 2005, the Company mailed the following notice to its customers:

PLEASE READ
UTILITY SOURCE, LLC

IMPORTANT NOTICE REGARDING WATER AND WASTEWATER RATES

> On January 4, 2005, the Arizona Corporation Commission ("Commission") approved Utility Source, LLC's (the "Company") request to provide water and wastewater service to the Flagstaff Meadows Development. Although the Commission [had] not authorized the Company to provide those services, the water and wastewater rates currently in effect were not approved by the Commission, because the Company commenced operations without Commission authority. Therefore, the setting of initial rates that support the construction and long-term operations of water and wastewater systems for the planned development occurred without Commission authority. The current rates were artificially set by the Company and may not be sufficient to cover the on-going costs of providing service. Therefore, in an attempt to balance equities between the Company and its customers and to provide adequate notice, the Commission has required the Company to file a rate application by May 1, 2006, that may result in higher rates. Customers will be given notice of that filing when made, which shall include the Commission Staff's estimate of proposed rate levels. You will have an opportunity to be heard before the Commission regarding that application.

(Affidavit of Mailing docketed on February 3, 2005, in Docket No. WS-04235A-04-0073).

Decision No. 67446 denied the Company's request for approval of a hook-up fee tariff, noting the following:

> [T]he utility company and the developer are one and the same, and the developer has, to this point, apparently chosen to install the entirety of the system without using advances or contributions, thereby inflating the Company's rate base and thus rates that may ultimately be paid by customers. We believe it is inappropriate to allow the Company/developer to benefit further from imposition of hook-up fees where the Company has made no effort to mitigate the potential rate effect on customers through the use of main extension agreements allowed under Commission rules.

(Decision No. 67446 at 8, Findings of Fact No. 16).

Decision No. 67446 also denied the Company's request for long-term debt, stating the following:

> Utility Source has not availed itself of the opportunity to negotiate main extension agreements but by its actions has, instead, pursued a development strategy that will potentially have the effect of saddling the Company's customers with unduly burdensome rates. We do not believe it is appropriate to add an additional financial burden on the Company's customers by approving a financing proposal that further insulates the utility company/developer from risk.

(Decision No. 67446 at 9, Findings of Fact No. 21).

B. APPLICATION

Utility Source filed its rate application on May 1, 2006. Staff found the application sufficient on July 3, 2006, following Utility Source's provision of supplemental information. The application is based on a test year ending December 31, 2005. At the end of the test year, the Company served 337 customers through its Water Division and its Sewer Division.

1. Water Division

For its water division, the application requested a revenue increase of $401,166, or a 230.03 percent increase over test year adjusted operating income of ($77,896). Utility Source later amended its request to a revenue increase of $312,361, or a 179.18 percent increase over test year adjusted operating income of ($23,286). Staff recommends a revenue increase of $192,858, or a 110.63 percent increase over adjusted test year operating income of ($21,340).

2. Sewer Division

For its sewer division, the application requested a revenue increase of $187,117, or a 164.27 percent increase over test year adjusted operating income of ($40,014). Utility Source later amended its request to a revenue increase of $139,654, or a 122.61 percent increase over adjusted test year operating income of ($22,959). Staff recommends a revenue increase of $121,549, or a 106.71 percent increase over adjusted test year operating income of ($22,441).

C. RATE BASE

Staff recommends, and the Company has accepted, several disallowances from the

Company's proposed plant in service for its water and sewer divisions, based on lack of substantiation of the used and usefulness of plant at the end of the test year.

1. <u>Water Division</u>

The Company proposes an adjusted original cost rate base ("OCRB") of $2,753,096 for its water division. The Company did not file reconstruction cost new less depreciation ("RCND") schedules. The Company's proposed OCRB includes its Deep Well Number Four in plant in service. Staff presented three separate scenarios for consideration. Staff recommends that the Commission adopt its Scenario One, which includes the Company's Deep Well Number Four in plant in service, for an adjusted OCRB of $2,753,095. Staff's Scenario Two includes the same adjusted OCRB of $2,753,095, and Staff's Scenario Three excludes Deep Well Number Four from plant in service, with an adjusted OCRB of $2,053,793.

a. Plant in Service

Staff's engineering analysis found that Deep Well Number Four was not used and useful during the test year. The Company does not dispute this finding. However, the Company proposes to include the $736,583 cost of Deep Well Number Four in plant in service in conjunction with a revenue requirement reduction proposal. The Company proposes to add pro forma revenues to actual test year revenues, in order to reduce its revenue requirement in this case. The proposed pro forma revenues are equivalent to an amount that would be received if 350 additional customers had existed in the test year. Inclusion of those pro forma revenues, along with inclusion of Deep Well Number Four in rate base, would have the effect of a lower rate increase than would otherwise be required. The Company believes that if the pro forma revenues are included, it is equitable to also include Deep Well Number Four in plant in service. The Company explains that its proposal to include the well in plant in service is equitable because it will be necessary to use Deep Well Number Four to serve actual new customers when they become connected to the system and begin using water and providing actual revenues to the Company.

Staff supports the Company's proposal, and advocates for the adoption of Staff's Scenario One, which includes Deep Well Number Four and the pro forma test year revenues from 350 customers who will one day be served by that well.[3]

The Company asserts that its proposal to include Deep Well Number Four in rate base, along with pro forma revenues from 350 future customers, will benefit current customers by spreading costs over an artificially larger customer base than currently exists. The Company's witnesses testified that when the impact of the revenue requirement based on the test year number of customers was calculated, the Company was dissatisfied with the effect on customer rates (Tr. at 38). The Company's managing member, Mr. Lonnie McCleve, testified that in order to reduce the rate impact, the Company decided to include a pro forma adjustment to revenues to include revenues it expected to receive when Flagstaff Meadows Unit 3 is built and the customers from that development begin taking service (Tr. at 38). Mr. McCleve stated that while the Company used 350 customers to estimate the pro forma revenues, the actual number of customers in Flagstaff Meadows Unit 3 will actually be fewer, closer to 270 (*Id.* at 39). The Company's accounting witness testified that without the pro forma revenues proposed by the Company, the rate increase necessary to reach the Company's revenue requirement would be over 300 percent (Tr. at 85). The Company believes that the effect of including both Deep Well Number Four and the pro forma revenues matches revenues, expenses, and plant, and that its proposal is consistent with the concept of gradualism in changes to customers' rates in order to avoid rate shock.

Under the unique circumstances of this case, we find the Company's proposal to include Deep Well Number Four in plant in service, in conjunction with the Company's proposal to add pro forma revenues from 350 customers to test year revenues in order to reduce the Company's revenue requirement, and therefore the rate impact on current customers, to be reasonable, and will adopt it. We agree with the Company and Staff that if the pro forma revenues are included in the test year revenues, it is proper to also include in rate base the cost of Deep Well Number Four, which will be required to serve the customers when they come on line. The plant in service balance for the Company's water division is therefore $3,195,818, which, with accumulated depreciation of

[3] Staff's Scenario Two also includes the Company's Deep Well Number Four in plant in service, whereas Staff's Scenario Three excludes Deep Well Number Four and also excludes the pro forma test year revenues. As discussed in the Fair Value Rate of Return section of the discussion below, in light of the significant rate impact of this case for the Company's customers, Staff is also recommending, in its Scenario One, a downward adjustment to the fair value rate of return for the Company's water division, in addition to inclusion of the 350 pro forma customers proposed by the Company.

$164,185, results in a net plant in service balance of $3,031,633.

b. Contributions in Aid of Construction

The Company's proposed rate base for the water division includes contributions in aid of construction ("CIAC") in the amount of $294,745, with accumulated amortization of $16,207, for a balance of $278,538. This amount is not in dispute and will be adopted.

c. Water Division OCRB

Subtracting the CIAC balance of $278,538 from the net plant in service balance of $3,031,633 results in an OCRB for the Company's water division of $2,753,095.

d. Water Division FVRB.

The Company did not file RCND schedules, and we find that the water division's OCRB is its fair value rate base ("FVRB"). The Company's FVRB for its water division is $2,753,095.

2. <u>Sewer Division</u>

The Company proposes an adjusted OCRB of $1,111,382 for its sewer division. Staff recommends an adjusted OCRB of $1,113,582.

a. Plant in Service

The Company and Staff agree on a gross plant in service balance of $1,379,092. Staff recommends an adjusted accumulated depreciation balance of $79,962, and a net plant in service balance of $1,299,130, while the Company proposes an adjusted accumulated depreciation balance of $82,161, and a slightly different net plant in service balance of $1,296,931. The Company accepted Staff's recommended downward adjustment to the Company's Treatment and Disposal Equipment account in the amount of $216,389, but its schedules disagree with Staff's accompanying downward adjustment in the amount of $16,229 to the Company's proposed accumulated depreciation balance of $96,191, showing an adjustment of $14,030 instead. In an April 11, 2007, filing, Staff stated that the Company's accumulated depreciation amount was in error, and noted a disaccord in the depreciable plant balances on the Company's rejoinder schedules. While neither party addressed the discrepancy between the parties' computations of accumulated depreciation on brief, it appears to stem from the unexplained disaccord in depreciable plant balances appearing in the Company's rejoinder schedules. Staff's proposed net plant in service balance of $1,299,130 for the Company's sewer division corrects for that balance, and will be adopted.

b. Contributions in Aid of Construction

The Company and Staff are in agreement on the Company's proposed CIAC in the amount of $197,973, with accumulated amortization of $12,425, for a net CIAC balance of $185,548.

c. Sewer Division OCRB

Subtracting the CIAC balance of $185,548 from the net plant in service balance of $1,299,130 results in an OCRB for the Company's sewer division of $1,113,582.

d. Sewer Division FVRB

The Company did not file RCND schedules, and we find that the sewer division's OCRB is its FVRB. The Company's FVRB for its sewer division is $1,113,582.

D. REVENUES

1. <u>Water Division</u>

The Company's proposed test year adjusted revenues for its water division of $174,328 include $83,560 of pro forma revenues from 350 future customers. Staff supports the Company's proposal to include the pro forma revenues, along with the inclusion of existing plant in rate base that will be necessary to serve those customers, as discussed above. Under the circumstances of this case, in order to alleviate the rate impact that would result without the two-part proposal, we will adopt test year adjusted revenues for the Company's water division of $174,328.

2. <u>Sewer Division</u>

There is no disagreement between the Company and Staff for test year adjusted revenues for the Company's sewer division of $113,905, and this amount will be adopted.

E. EXPENSES

1. <u>Water Division</u>

The Company proposes total operating expenses for its water division of $197,613, while Staff recommends $195,667. There is no disagreement between the Company and Staff for test year expenses for Utility Source's water division other than the amount of property tax expense. The Company's property tax expense estimate is higher than Staff's based on the Company's proposed revenue requirement, which is higher than Staff's due to the Company's higher proposed fair value rate of return ("FVROR"). Other than property tax expense, the test year expenses as proposed by the Company are reasonable and will be adopted. Because we are adopting the Staff's FVROR recommendation, for the reasons discussed further below, we adopt Staff's recommended property tax expense level, for total test year operating expense of $195,667 for Utility Source's water division.

2. Sewer Division

The Company proposes total operating expenses for its sewer division of $136,864, while Staff recommends $134,871. As with the water division, there is no disagreement between the Company and Staff for test year expenses for the sewer division other than the amount of property tax expense. The Company's property tax expense estimate is higher than Staff's based on the Company's proposed revenue requirement, which is higher than Staff's due to the Company's higher proposed FVROR. Other than property tax expense, the test year expenses as proposed by the Company are reasonable and will be adopted. Because we are adopting the Staff's FVROR recommendation, for the reasons set forth further below, we adopt Staff's recommended property tax expense level, for total test year operating expense of $134,871 for Utility Source's sewer division.

F. COST OF CAPITAL

1. Capital Structure

The Company and Staff agree that an appropriate capital structure in this case is the Company's actual capital structure of 100 percent equity.

2. Cost of Equity

The cost of equity component of a cost of capital determination must be estimated. Both the Company and Staff provided estimates arrived at through use of financial models. The Company recommended a cost of equity of 10.5 percent. Staff recommended a cost of equity of 8.9 percent.

a. Company

The Company's cost of capital witness, Thomas J. Bourassa, recommended that the Company be granted a 10.5 percent cost of capital and rate of return. He based his recommendation on the results of his discounted cash flow ("DCF") analysis, his risk premium analysis, and his comparable earnings analysis performed on a proxy group of companies that includes American States Water, Aqua America, California Water, Connecticut Water Services, Middlesex Water, and SJW Corporation. Mr. Bourassa performed three DCF analyses: a constant growth (earnings growth) analysis, with results in a range from 9.7 percent to 12.0 percent, and a midpoint of 10.9 percent; a constant growth (sustainable growth) analysis, with results in a range from 8.2 percent to 10.5 percent, and a midpoint of 9.4 percent; and a two-stage growth model, with results in a range from 9.2 percent to 11.5 percent, and a midpoint of 10.4 percent. Mr. Bourassa performed two risk premium analyses: one using actual returns, with the result of 10.2 percent; and one using authorized returns, with results in a range from 10.8 percent to 11.3 percent, with a midpoint of 11.1 percent. Mr. Bourassa's two comparable earnings analyses yielded results as follows: using actual returns, his results ranged from 4.2 percent to 11.7 percent, and a midpoint of 8.0 percent; using authorized returns, his results ranged from 9.9 percent to 12.7 percent, with a midpoint of 11.3 percent. Mr. Bourassa also provided Value Line Investment Survey's Industry Composites for 2006 (9.0 percent); for 2007 (10.0 percent), and for 2009 (10.5 percent).[4]

For his DCF models, the Company's witness used analysts' forecasts of earnings per share ("EPS") growth for the near term and average long-term gross domestic product ("GDP") growth, using the arithmetic mean, for the long term. Mr. Bourassa testified that he chose not to use forecasted dividend per share ("DPS") growth in his DCF model, because "[w]hen forecasted dividend growth is used in the DCF model, it produces a cost of equity below the cost of debt" (Direct Testimony of Thomas J. Bourassa at 27). To determine his estimates of sustainable growth used in the DCF formula, Mr. Bourassa used forecasts of book returns, retention ratios, and growth in the number of common shares from Value Line Investment Survey (Bourassa Dt. at 26).

To calculate the EPS growth rate for his DCF models, Mr. Bourassa used forecasts for the proxy companies published by Zack's Investment Research, Standard & Poor's Earnings Guide, and Value Line Investment Survey (Bourassa Rj. at 7). Mr. Bourassa believes that using analysts' forecasts from several reputable sources offsets potentially overly optimistic or overly pessimistic projections from one source. Mr. Bourassa explained that he did not provide an EPS growth rate

[4] These results are from Mr. Bourassa's Rejoinder Testimony, which updated his previous analysis using more recent data. As Mr. Bourassa stated, the results changed very little.

projection for Connecticut Water or SJW Corporation, because growth estimates were not available from at least two independent sources. Likewise, he provided no EPS growth rate projection for Middlesex Water in his Rebuttal and Rejoinder Testimony filings, because only one growth rate estimate from an independent source was available, whereas two were available at the time he prepared his Direct Testimony filing (Bourassa Rj. at 7). Mr. Bourassa testified that if he had used the single source published EPS estimates available for Middlesex and Connecticut Water Services, it would have resulted in an increase in the Company's EPS estimate from 8.3 percent to 8.6 percent (Bourassa Rj. at 8).

Mr. Bourassa excluded historical DPS and EPS growth rates for the proxy companies from his DCF analysis (Bourassa Rb. at 20). The witness testified that one of the reasons he excluded this historical data is because the indicated cost of equity produced by the DCF model using historical growth rates is less than the current cost of debt, and he is critical of Staff's use of historical DPS and EPS growth rates in its calculations (*Id.*). Mr. Bourassa points out that Value Line's published projected EPS and DPS growth rates for the proxy companies are significantly higher than Staff's computed growth rate, and he believes that Staff's witness chose inputs that "skewed" Staff's results downward (Bourassa Rj. at 12).

The Company did not perform a capital asset pricing model ("CAPM") analysis, but criticized Staff's CAPM analysis for its use of median dividend yields and median price appreciation for growth, as opposed to using average dividend yields and price appreciation.

The Company disagrees with Staff's position that firm size is a unique, diversifiable risk. The Company believes that risks associated with small size, lack of diversification, limited revenue and cash flow, small customer base, lack of liquidity, regulatory risk, and construction risk are common to small water utilities, and are unique only in the sense that large publicly traded water utilities do not possess the same levels of risk, but states that no market data exist to directly assess how an investor would price those risks (Bourassa Rj. at 14). Utility Source argues that the California Public Utilities Commission, in a 1992 decision, concluded that smaller utilities are more risky than larger ones and required higher equity returns (Bourassa Rb. at 17).

b. Staff

In arriving at its cost of equity recommendation, Staff used the constant growth DCF model, the multi-stage DCF model, and the CAPM. Staff arrived at its CAPM estimates using two CAPM models; one using a historical market risk premium, reaching an estimate of 11.0 percent, and one using a current market risk premium, reaching an estimate of 7.8 percent.

Staff averaged its DCF results from the constant growth DCF model (7.7 percent) and the multi-stage growth DCF model (9.1 percent), for an average of 8.4 percent, then averaged that with the average of its two CAPM models (9.4 percent), to reach its recommended cost of equity recommendation of 8.9 percent.

Staff's witness calculated the growth factor for its constant growth DCF model by averaging historical and projected EPS, DPS, and sustainable growth, giving them equal weight. While Utility Source criticized Staff's use of historical EPS and DCF growth as "unrealistic" because it resulted in indicated costs of equity at or below the cost of debt, Staff responded that its use of historic and forecasted DPS growth is consistent with DCF methodology, uses publicly accessible data which the investment community may consider in forming its growth expectations (Direct Testimony of Steven P. Irvine at 39), and that it would be inappropriate to exclude inputs that produce results that are too low or too high based on a comparison to a chosen benchmark (Irvine Sb. at 10-11). Staff disapproves of Utility Source's sole reliance on analyst's forecasts, because they are known to be overly optimistic and to suggest rates that are too high. Staff is critical of Mr. Bourassa's "solution" to this problem, which was to take his source data from at least two independent sources of analysis, because, Staff argues, using multiple sources of analysts' forecasts only compounds the methodological flaw, rather than providing a remedy for it.

Staff estimated the beta for Utility Source to use in its CAPM analysis using the same sample of proxy companies Utility Source used in its DCF analysis. Staff's CAPM formula used current interest rates, and not forecasted interest rates for the timeframe new rates will be in effect, as the Company would prefer, because it is impossible to predict interest rates (Irvine Dt. at 41). Staff believes that present rates are more appropriate than forecasted rates, because analysts do not have any more information about the future than what is already reflected in the current rate, and that the best indicator of tomorrow's yield is today's yield (Irvine Sb. at 9).

In response to the Company's criticism that the current market risk premium Staff used in its CAPM analysis is unstable, Staff points out that market risk premium results reflect changes in the market rather than any instability of the methodology itself (*Id.* at 12). Staff states that its CAPM model averages a historical market risk premium with the current market risk premium in order to mitigate the potentiality of market volatility exerting an influence on the market-based CAPM model (Irvine Dt. at 27). Staff defended its use of arithmetic averages in its CAPM analysis, and of median values to derive the dividend yield and growth rate for its DCF method, noting that it uses both arithmetic and geometric means in its analyses because it leads to a more balanced approach, and that while the choice between the two can be confusing, each can be appropriate depending on whether the growth being averaged is historic or prospective (Staff Br. at 6-7; Irvine Sb. at 11).

Staff is critical of Utility Source's reliance on a bond risk premium analysis to justify its recommendation for a cost of equity higher than the average of its three DCF analyses. Staff stated that while Utility Source attempted to characterize its bond risk premium analysis as market based because it used market data, it is inherently not a market based approach, as it is susceptible to inappropriate reliance on subjective, judgment-based adjustments. Similarly, Staff argues that the Company's comparable earnings approach for cost of equity estimation is unreasonable, because there are numerous reasons why the returns authorized for the sample utilities in prior rate cases cannot be compared directly to current market expectations, and that actual returns should therefore not be equated with cost of equity (Irvine Sb. at 8-9).

c. Conclusion

The Company's use of the risk premium and comparable earnings methodologies for cost of equity estimation rely extensively on non-market based data and forecasts, and we have consistently rejected their use for that reason. While the Company argues that Staff's cost of equity recommendation is not supported by substantial evidence, we disagree. Staff's cost of equity recommendations were reached using market based financial models that used both historical and forecasted economic information, and which are widely accepted in the financial industry and by state utility commissions. As the Company's witness stated in his direct testimony, the DCF model requires judgment in selection of appropriate growth rates (Bourassa Dt. at 21). We find that Staff's DCF methodology for estimating Utility Source's cost of equity is balanced, unlike that of the Company, in that it did not exclude inputs that tend to either increase or decrease results, and did not rely exclusively on analysts' growth forecasts, which are known to be overly optimistic. Likewise, we find Staff's CAPM analysis to be a more objective market based approach to cost of equity estimation than Utility Source's comparable earnings approach or its bond risk premium analysis, and therefore more reliable.

Further, we do not find the Company's arguments in favor of a risk premium convincing. We find that premiums for small firm size are inappropriate, because such risk is diversifiable, and premiums should not be provided for risks that an investor may eliminate through diversification.

3. Cost of Capital Summary

For the reasons stated above, we adopt Staff's recommendation for a cost of equity of 8.9 percent:

	Percentage	Cost	Weighted Cost
Long-Term Debt	00.0%	0.0%	0.0%
Common Equity	100%	8.9%	8.9%
Weighted Average Cost of Capital			8.9%

4. Fair Value Rate of Return

As is evident from a review of the record of Decision No. 67446, the background of this case renders it unique. Staff argues that gradualism is an issue in this case because of the across the board increase all the Company's customers are facing. The Company has also acknowledged the existence of the issue of gradualism. In consideration of the unique circumstances of this case, Staff is recommending that its 8.9 percent estimated cost of capital recommendation be applied, unadjusted, as the FVROR to the Company's FVRB for its sewer division, but that it be adjusted downward for the FVROR to be applied to the Company's water division FVRB. Staff states that if its 8.9 percent estimated cost of capital were to be applied, unadjusted, to the water division FVRB, the resulting rate increase would be precipitous, approaching the level of rate increase that we rejected in Decision No. 67446 as being unconscionable. In the case leading to that Decision, Staff had recommended that initial rates be set at a level approximately 189 percent over the unauthorized rates set by, and being charged by, the homeowners' association, and we found such a level of increase to be unreasonable. Staff recommends a FVROR for the water division of 6.23 percent, and for the sewer division of 8.9 percent. Staff believes its FVROR recommendation in this case is appropriate when all relevant factors are considered, including the history of unauthorized rates, the inclusion of plant not used and useful during the test year in rate base, the concept of gradualism, and the "hybrid" nature of this case because it stems from Decision No. 67446, which granted a CC&N, but ordered a rate case to be filed prior to the typical five-year period normally ordered when a CC&N is granted (Staff Br. at 16, 17). Staff contends that adoption of its FVROR recommendation will not prevent the Company from receiving a just and reasonable return on FVRB (*Id.*). Staff states that if its FVROR recommendations are adopted, the revenue increases for the water division and the sewer division will be at approximately the same level, at 110 percent and 106.71 percent, respectively.

Under the alternative Scenario Two that Staff presented, which includes the same FVRB and pro forma revenues as Staff's recommended Scenario One, and which applies a rate of return of 8.9 percent, the revenue increase for the water division would be 153.29 percent. Under Staff's alternative Scenario Three, which excludes Deep Well Number Four and the pro forma revenues, and which applies rate of return of 8.90 percent, the revenue increase for the water division would be 286.63 percent.

Utility Source is opposed to Staff's recommended FVROR for the water division, and argues that the fact that Staff made a computation to arrive at its recommendation renders it "inappropriate," "illegal," inconsistent with the *Simms* standard,[5] and in violation of Arizona law (Company Br. at 8-12).

The Company further argues that the 6.23 percent and 8.9 percent FVRORs recommended by Staff are "illegal and unreasonable," because Staff did not test their reasonableness against the market price for Baa bonds or the prime rate, and because they do not immediately provide the Company with a positive operating margin (Company Br. at 12-13). Utility Source also disagrees with Staff's characterization of this case as a "hybrid" between a CC&N application and a rate application.

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[5] *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956).

Mr. Hitesman contends in his post-hearing brief that the rate increases proposed by both the Company and Staff are not reasonable from the customers' perspective, and he questioned whether evidence was presented regarding the Company's legal obligation to provide service to its customers at reasonable rates. Mr. Hitesman believes that the proposed rate increases will have an unreasonable, severe impact on Utility Source's customers, who he believes live in a low income community and are also bearing unreasonably high real estate costs. Mr. Hitesman believes that Utility Source's customers assumed, when they moved into the development served by the Company, either 1) that rates would either remain the same as those currently in effect, or 2) would be the rates specified in the Declaration of Covenants, .Conditions and Restrictions for Flagstaff Meadows Property Owner's Association ("CC&Rs"), both of which are lower than the increases requested by the Company or proposed by Staff. Mr. Hitesman argues that the proposed rates are higher than those charged by the City of Flagstaff, higher than average rates in Coconino County, and higher than average rates in the State of Arizona. Mr. Hitesman believes that Utility Source has a high-producing group of wells, and that the Company's water capacity provides assurance of the Company's long-term sustainability. Mr. Hitesman states that there is no question that a profitable utility is crucial for his community, but requests that the Commission balance the ratepayers' interests with ensuring the profitability of the Company.

The Commission has discretion to consider all relevant and necessary factors in the exercise of our constitutional rate setting authority, to ensure that the rates charged by utilities under our jurisdiction are just and reasonable for both utility companies and their ratepayers. Like Mr. Hitesman, we have been concerned, and remain concerned, with the impact on ratepayers of the required increase in rates from the unauthorized, artificially low levels charged by the developer of Flagstaff Meadows, to the level necessary to allow Utility Source to provide adequate service. Due to our concern over the impact on ratepayers of the size of a rate increase that reflected the projected cost of service over a five year timeframe, we did not authorize a rate increase in Decision No. 67446. Instead, we ordered the Company to file a rate case sooner than would otherwise be required, in order to give us the ability to examine actual operating information as opposed to projections. We were also concerned that customers have adequate notice of a possible increase in rates. For that reason we ordered the Company, in Decision No. 67446, to provide notice to its customers that the rates resulting from the ordered rate case filing would likely be higher than the rates we authorized in Decision No. 67446.

Staff is correct in its argument that making appropriate adjustments to the rate of return applied to the FVRB is an appropriate means of setting just and reasonable rates, even if such adjustments may fall outside the parameters of a strict cost of capital analysis (*See* Staff Br. at 16-17). We have accepted the Company's proposal to include plant in rate base that was not used and useful during the test year, which directly reduces risk to the Company, and is properly reflected as an adjustment to the FVROR for the water division. According to Staff, Staff's recommended FVROR of 6.23 percent for the water division, and 8.9 percent for the sewer division, when applied to the FVRB, will provide the Company with an operating margin of 47 percent for the water division and 41 percent for the sewer division, when the pro forma revenues proposed by the Company and adopted herein are included (Surrebuttal Testimony of Jeffrey M. Michlik, Exh. S-2 at 10). While the Company protested that its proposal to include pro forma revenues should not be considered when discussing estimated operating margins, we disagree, because the Company's proposal was made as part of an overall proposal to include Deep Well Number Four, which will be necessary to serve the new customers, in rate base at this time. While the Company disagrees with Staff's characterization of this case as a "hybrid" between a CC&N application and a rate application, we find that characterization to be particularly apt, because we declined to set the Company's rates in the CC&N application proceeding based on five year projections, but ordered the Company to file the instant rate application instead. In addition, with Staff's FVROR recommendation applied to FVRB, the Company will be in approximately the same position it would have been had it obtained its CC&N in the normal and proper legal and procedural manner, in which new companies are not expected to immediately have positive operating margins (*See* Staff Br. at 19, referencing figures in the Rejoinder Testimony of Thomas J. Bourassa, Exh. A-5, Attached Rejoinder Exhibit 1 at pages 3 and 7). Considering all the unique facts associated with this case and the CC&N proceeding, we find that the FVROR recommendation of Staff is just and reasonable under the unique circumstances of this case, and we will therefore adopt it.

G. AUTHORIZED INCREASE

Based on our findings herein, we determine that Utility Source is entitled to a gross revenue increase of $192,688 for its water division.

FVRB	$2,753,095
Adjusted Operating Income	(21,340)
Required FVROR	6.23%
Required Operating Income	171,518
Operating Income Deficiency	192,858
Gross Revenue Conversion Factor	1.0000
Gross Revenue Increase	$192,858

Based on our findings herein, we determine that Utility Source is entitled to a gross revenue increase of $121,549 for its sewer division.

FVRB	$1,113,582
Adjusted Operating Income	(22,441)
Required FVROR	8.90%
Required Operating Income	99,109
Operating Income Deficiency	121,549
Gross Revenue Conversion Factor	1.0000
Gross Revenue Increase	$121,549

H. RATE DESIGN

Both the Company and Staff propose using an inverted tier rate design for residential water division customers. The Company's rate design also includes an inverted rate design for irrigation customers.

Staff is critical of the breakpoint for the first block in the Company's proposed water rate design, stating that it can have the effect of delaying the point at which a customer will experience increasing rate impact from increased usage, thereby obscuring the price signal that an inverted rate design is intended to send (Tr. at 140). Staff also opposes the Company's proposal to switch to an inverted tier rate design for irrigation customers (Surrebuttal Testimony of Jeffrey M. Michlik, Exh. S-2 at 13). The Company did not address rate design issues on brief. Staff's proposed rate design is reasonable and will be adopted.

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Utility Source is an Arizona public service corporation providing water and sewer service to an area located approximately eight miles west of Flagstaff, near Bellemont, in Coconino County, Arizona pursuant to authority granted by the Commission in Decision No. 67446 (January 4, 2005).

2. At the end of the test year, Utility Source provided service to approximately 337 water and sewer customers.

3. On May 1, 2006, Utility Source filed an application for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for water and wastewater utility service provided to customers in the Company's service area in Coconino County, Arizona.

4. On May 31, 2006, Staff filed a letter stating that the Company's application had not met the sufficiency requirements pursuant to A.A.C. R14-2-103.

5. On June 16, 2006, Utility Source filed additional information in response to Staff's deficiency letter.

6. On July 3, 2006, Staff filed a letter indicating that the Company's application had met the sufficiency requirements, and classifying the Company as a Class C utility.

7. By Procedural Order issued July 10, 2006, a hearing in this matter was scheduled for January 22, 2007, and other procedural deadlines were established.

8. On August 16, 2006, the Company filed an Affidavit of Mailing, and on August 25, 2006, filed an Affidavit of Publication.

9. Public comments in opposition to the rate increase were filed on August 25, 2006, September 20, 2006, September 26, 2006, September 28, 2006, October 2, 2006, October 6, 2006, October 13, 2006 (five separate comments), October 20, 2006, October 24, 2006, October 27, 2006, November 21, 2006, February 2, 2007, April 6, 2007 (four separate comments), and April 27, 2007.

10. On September 26, 2006, the Ponderosa Fire District filed a Motion to Intervene as a customer of the Company. No opposition to the request was received, and the Motion to Intervene was granted by Procedural Order issued November 8, 2006.

11. On October 25, 2006, Staff filed a Motion to Extend Filing Deadline and Schedule Procedural Conference, stating that Staff had not received adequate information from the Company regarding plant in service and that data responses from the Company had taken longer than the time allowed. Staff requested that the deadline for filing of its Direct Testimony be extended by 60 days, and that a procedural conference be scheduled to discuss adjustment of other filing deadlines and other procedural matters.

12. On November 8, 2006, a Procedural Order was issued scheduling a procedural conference for November 28, 2006.

13. On November 14, 2006, Mr. David Hitesman and Mr. Dennis Jones filed a Motion to Intervene. The Motion to Intervene included a request that the Commission hold a hearing in the Coconino County Board of Supervisors Meeting Room. Attached to the Motion to Intervene was a petition signed by over 100 customers of the Company requesting that a hearing be held in Bellemont, Arizona, where the Company is located. The petition also included a request that the Commission consider postponing the proposed rate increase until an additional 260 homes planned to connect to the Utility Source system are completed.

14. On November 28, 2006, the Procedural Conference was convened as scheduled. The parties were directed to confer and recommend a procedural schedule.

15. On November 30, 2006, Staff filed a Notice of Filing Recommended Schedule Changes.

16. On December 19, 2006, the Ponderosa Fire District submitted its Commentary & Exhibits of Intervention in Response to the Proposed Rate Increases by Utility Source LLC.

17. On December 20, 2006, a Procedural Order was issued granting the Motion to intervene by David Hitesman and Dennis Jones. The Procedural Order also continued the hearing date to April 3, 2007, continued related procedural deadlines, and extended the applicable timeclock in this case by 75 days.

18. On January 10, 2007, Staff filed a Motion for Extension of Deadline requesting additional time to file its Direct Testimony. On January 12, 2007, the Company filed its Response to Staff's Motion, stating that it did not object to the time extension, provided other deadlines remained

unchanged.

19. On January 16, 2007, intervenors David Hitesman and Dennis Jones filed a document titled Evidence for Docket No. WS-04235A-06-0303. Therein, the intervenors state that the rate increase proposed by the Company is unreasonable and should therefore not be approved, pursuant to A.R.S. § 40-361.A. Intervenors state that the community's CC&Rs provide for water and wastewater use assessments for each lot for which a building permit for a residence has been issued, and that it is reasonable for residents to assume that their utility bills would be bound by the terms of the CC&Rs; that the proposed rate increase is a 197 percent increase over current rates and 142 percent over rates dictated by the CC&Rs; that the increase constitutes 2.8-3.2 percent of the Average Household Income for Coconino County; that although the Company currently serves 326 residential customers, plans are underway to increase the customer base by 274 residential customers, reducing the need for a significant rate increase; that the proposed rates are greater than average water and wastewater rates for the City of Flagstaff, Coconino County, and the State of Arizona; and that the City of Flagstaff's well capacity is approximately 1,263 gallons per day ("gpd') for 15,300 residential customers, compared with the Company's 67 percent higher well capacity of approximately 2,111 gpd for 326 residential customers.

20. On January 19, 2007, Staff filed the Direct Testimony of Jeffrey M. Michlik, Steven P. Irvine, and Jian W. Liu.

21. On January 22, 2007, the date originally noticed as the date of the hearing in this matter, the hearing was convened for the purpose of taking public comment. Counsel for the Company and Staff appeared. No members of the public appeared to provide public comment.

22. On January 25, 2007, a Procedural Order was issued setting a public comment session at the Coconino County Board of Supervisors Meeting Room in Flagstaff, Arizona, for March 19, 2007 at 5:00 p.m.

23. On February 16, 2007, the Company filed the Rebuttal Testimony of Thomas J. Bourassa.

24. On March 5, 2007, Staff filed a Motion for Extension and Request for Scheduling Conference in order to address issues raised by a change in the Company's position in this case.

25. On March 13, 2007, Staff filed a Notice of Filing Recommended Schedule Changes, recommending that the hearing be moved to May 1, 2007, and that other procedural deadlines be moved accordingly.

26. On March 16, 2007, a Procedural Order was issued continuing the hearing in this matter to May 1, 2007, and continuing other procedural deadlines accordingly.

27. On March 19, 2007, Staff filed the Surrebuttal Testimony of Jeffrey M. Michlik and Steven P. Irvine.

28. On March 19, 2007, a Special Open Meeting of the Commission was convened in the Coconino County Board of Supervisors Meeting Room in Flagstaff, Arizona, for the purpose of taking public comment on the Company's application. Numerous members of the public appeared, and eighteen customers spoke in order to provide their comments for the record in this proceeding.

29. On March 20, 2007, the Ponderosa Fire District filed its Exhibits in Response to the Proposed Rate Increases Submitted by Utility Source LLC Rebuttal and Arizona Corporation Commission Testimony. Therein the District stated that "[s]ince the existing customers may possibly have already paid part or all of the development costs of the utility system, any to date revenue deficits should be considered as part of the overall development cost because the rates were knowingly set abnormally low as an enticement for homebuyers."

30. On March 21, 2007, Staff filed Revised Surrebuttal Testimony to reflect corrected schedule information.

31. On March 27, 2007, comments labeled with the heading "NOTE: The Commission received this document from intervenor Dennis Jones at the public comment session conducted in Flagstaff, AZ, on March 19, 2007, in Docket No. WS-04235A-06-0303" were filed in the docket.

32. On April 2, 2007, the Company filed the Rejoinder Testimony of Thomas J. Bourassa.

33. On April 6, 2007, the Company filed the Supplemental Rejoinder Testimony of Lonnie McLeve regarding the customer comments at the March 19, 2007 Public Comment Meeting held in Flagstaff, Arizona.

34. On April 11, 2007, Staff submitted revised schedules in response to the Rejoinder Testimony of Thomas J. Bourassa filed on April 2, 2007.

35. On April 13, 2007, the Pre-Hearing Conference was convened as scheduled. Counsel for the Company and Staff appeared.

36. On April 18, 2007, a Procedural Order was issued continuing the hearing to May 2, 2007.

37. On April 27, 2007, the Company filed a Motion for Continuance due to unavailability of counsel.

38. On April 30, 2007, a Procedural Order was issued continuing the hearing to June 19, 2007, and suspending the applicable timeclock during the continuance.

39. The hearing commenced as scheduled on June 19, 2007, before a duly authorized Administrative Law Judge of the Commission. The Company and Staff appeared through counsel and presented evidence. Intervenors Mr. Starr Lamphere, Mr. David Hitesman, and Mr. Dennis Jones appeared, each on his own behalf.

40. On June 22, 2007, Staff filed schedules that were requested by the Administrative Law Judge during the hearing.

41. On June 29, 2007, the Company filed Comments On and Objections to Late-Filed ALJ Scenario Number 4.

42. On July 10, 2007, the Company made a filing documenting compliance with Decision No. 67446. This filing addressed an issue raised at the hearing regarding ownership of wellsite property.

43. Closing Briefs were filed by the Company, Mr. Hitesman and Staff, and the matter was taken under advisement.

44. Current rates, the rates proposed by the Company, and the rates proposed by Staff for the water division are as follows:

	Present Rates	Proposed Rates	
		Company	Staff
MONTHLY USAGE CHARGE:			
5/8" x ¾" Meter	$ -	$35.74	$18.50
¾" Meter	$6.48	35.74	18.50
1" Meter	8.02	89.34	46.50

1 ½" Meter	9.62	178.69	92.50
2" Meter	14.00	285.90	148.00
3" Meter	-	571.80	296.00
4" Meter	58.00	893.43	462.50
6" Meter	89.80	1,786.86	925.00

COMMODITY RATES

5/8" x ¾" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	N/A	N/A	N/A
From 6,001 to 15,000 Gallons	N/A	N/A	N/A
In excess of 15,000 Gallons	N/A	N/A	N/A
From 1 to 4,000 Gallons	N/A	$9.60	N/A
From 4,001 to 12,000 Gallons	N/A	12.48	N/A
Over 12,000 Gallons	N/A	16.22	N/A
From Zero to 4,000 Gallons	N/A	N/A	$4.80
From 4,001 to 9,000 Gallons	N/A	N/A	7.16
Over 9,000 Gallons	N/A	N/A	8.60
¾" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	$2.83	N/A	N/A
From 6,001 to 15,000 Gallons	3.32	N/A	N/A
In excess of 15,000 Gallons	4.71	N/A	N/A
From 1 to 4,000 Gallons	N/A	$9.60	N/A
From 4,001 to 12,000 Gallons	N/A	12.48	N/A
Over 12,000 Gallons	N/A	16.22	N/A
From Zero to 4,000 Gallons	N/A	N/A	$4.80
From 4,001 to 9,000 Gallons	N/A	N/A	7.16
Over 9,000 Gallons	N/A	N/A	8.60
1" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	$2.83	N/A	N/A
From 6,001 to 15,000 Gallons	3.32	N/A	N/A
In excess of 15,000 Gallons	4.71	N/A	N/A
From 1 to 30,000 Gallons	N/A	$12.48	N/A
Over 30,000 Gallons	N/A	16.22	N/A
From Zero to 27,000 Gallons	N/A	N/A	$7.16
Over 27,000 Gallons	N/A	N/A	8.60
1 ½ " Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	N/A	N/A	N/A

From 6,001 to 15,000 Gallons	N/A	N/A	N/A
In excess of 15,000 Gallons	N/A	N/A	N/A
From 1 to 60,000 Gallons	N/A	$12.48	N/A
Over 60,000 Gallons	N/A	16.22	N/A
From Zero to 57,000 Gallons	N/A	N/A	$7.16
Over 57,000 Gallons	N/A	N/A	8.60
2" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	N/A	N/A	N/A
From 6,001 to 15,000 Gallons	N/A	N/A	N/A
In excess of 15,000 Gallons	N/A	N/A	N/A
From 1 to 96,000 Gallons	N/A	$12.48	N/A
Over 96,000 Gallons	N/A	16.22	N/A
From Zero to 94,000 Gallons	N/A	N/A	$7.16
Over 94,000 Gallons	N/A	N/A	8.60
3" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	N/A	N/A	N/A
From 6,001 to 15,000 Gallons	N/A	N/A	N/A
In excess of 15,000 Gallons	N/A	N/A	N/A
From 1 to 192,000 Gallons	N/A	$12.48	N/A
Over 192,000 Gallons	N/A	16.22	N/A
From Zero to 195,000 Gallons	N/A	N/A	$7.16
Over 195,000 Gallons	N/A	N/A	8.60
4" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	N/A	N/A	N/A
From 6,001 to 15,000 Gallons	N/A	N/A	N/A
In excess of 15,000 Gallons	N/A	N/A	N/A
From 1 to 300,000 Gallons	N/A	$12.48	N/A
Over 300,000 Gallons	N/A	16.22	N/A
From Zero to 309,000 Gallons	N/A	N/A	$7.16
Over 309,000 Gallons	N/A	N/A	8.60
6" Meter (Residential & Commercial)			
Gallons Included in Minimum	0	0	0
Excess of Minimum – per 1,000 Gallons:			
From 1 to 6,000 Gallons	N/A	N/A	N/A
From 6,001 to 15,000 Gallons	N/A	N/A	N/A
In excess of 15,000 Gallons	N/A	N/A	N/A
From 1 to 600,000 Gallons	N/A	$12.48	N/A
Over 600,000 Gallons	N/A	16.22	N/A

From Zero to 615,000 Gallons	N/A	N/A	$7.16
Over 615,000 Gallons	N/A	N/A	8.60

Multi-Family Mobile home and Commercial Customers

All consumption per 1,000 gallons:	$2.97	$9.26	N/A

Irrigation Meters

Charge per 1,000 gallons for usage:	†	N/A	$9.26

Standpipe or Bulk Water

Charge per 1,000 gallons for usage:	$6.00	$10.35	$10.35

Construction Water

Charge per 1,000 gallons for usage:	$6.00	$10.35	$10.35

SERVICE LINE AND METER INSTALLATION CHARGES:
(Refundable pursuant to A.A.C. R14-2-405)

5/8" x ¾" Meter	-	-	$520.00
¾" Meter	$575.00	$575.00	575.00
1" Meter	660.00	660.00	660.00
1 ½" Meter	900.00	900.00	900.00
2" Turbine Meter	1,525.00	1,525.00	1,525.00
2" Compound Meter	-	-	2,320.00
3" Turbine Meter	-	-	2,275.00
3" Compound Meter	-	-	3,110.00
4" Turbine Meter	3,360.00	3,360.00	3,360.00
4" Compound Meter	-	-	4,475.00
6" Turbine Meter	6,035.00	6,035.00	6,035.00
6" Compound Meter	-	-	8,050.00

SERVICE CHARGES:

Establishment of Service	$20.00	$20.00	$20.00
Establishment of Service (After Hours)	40.00	40.00	40.00
Re-establishment of Service	*	*	*
Reconnection of Service	50.00	50.00	50.00
Reconnection (Delinquent and After Hours)	40.00	40.00	40.00
Charge for moving meter	Cost	Cost	Cost
After hours service charge	40.00	40.00	40.00
Minimum Deposit Requirement	**	**	**
Deposit Interest	3.00%	3.00%	Per Rule
Meter Test	20.00	20.00	20.00
Meter Re-Read	10.00	10.00	10.00
Charge for NSF Check	20.00	20.00	20.00
Late Payment charge for delinquent bill	1.50%	1.50%	***

Deferred Payment Finance Charge	1.50%	1.50%	***
Main Extension & Additional Facility Agreements	***	***	***

† The Company proposes that irrigation customers be charged Commodity Charges in the same manner as Residential and Commercial customers.
* Per Commission rule A.A.C. R-142-403(D).
** Per Commission rule A.A.C. R14-2-403(B).
*** Per Commission rule A.A.C. R14-2-406(B).

45. Current rates, the rates proposed by the Company, and the rates proposed by Staff for the sewer division are as follows:

	Present Rates	Proposed Rates Company	Staff
MONTHLY CHARGES:			
Rate per 1,000 gal. water usage:			
Residential	$2.73	$6.86	$5.84
Car washes, Laundromats, commercial, manufacturing	2.67	6.70	5.71
Hotel and Motels	3.58	8.99	7.66
Restaurants	4.42	11.09	9.46
Industrial Laundries	3.92	9.84	8.39
Waste Haulers	80.00	200.80	171.20
Restaurant Grease	70.00	175.70	149.80
Treatment Plant Sludge	80.00	200.80	171.20
Mud Sump Waste	250.00	627.50	535.00
SERVICE CHARGES:			
Establishment of Service	$20.00	$20.00	$20.00
Establishment of Service (After Hours)	40.00	40.00	40.00
Re-establishment of Service	*	*	*
Reconnection of Service	50.00	50.00	50.00
Reconnection (Delinquent and After Hours)	40.00	40.00	40.00
Minimum Deposit Requirement	**	**	**
Deposit Interest	3.00%	3.00%	Per Rule
Charges for NSF Check	20.00	20.00	20.00
Deferred Payment Finance Charge	1.50%	1.50%	***
Late Payment, Per Month	***	***	***
Service Calls, per hour (After Hours only)	40.00	40.00	40.00
Service Lateral Connection Charges:			
Residential	500.00	500.00	500.00
Commercial	Cost	Cost	Cost
Main Extension Tariff	Cost	Cost	Cost

* Per Commission rule A.A.C. R-142-603(D).
** Per Commission rule A.A.C. R14-2-603(B).
*** Per Commission rule A.A.C. R14-2-608(F).

46. According to the Company's application, in the test year ended December 31, 2005, Utility Source's water division had adjusted operating income of ($23,286) on an adjusted OCRB of $2,753,096, for a (-0.85) percent rate of return.

47. For its water division, Utility Source requests a revenue increase of $312,361, and Staff recommends a revenue increase of $192,858.

48. For purposes of this proceeding, we determine that Utility Source's water division has an OCRB and a FVRB of $2,753,095.

49. The increase proposed by Utility Source for its water division would produce an excessive return on FVRB.

50. For Utility Source's water division, a FVROR on FVRB of 6.23 percent is reasonable and appropriate, for the reasons discussed herein.

51. For its water division, Utility Source is entitled to a gross revenue increase of $192,858.

52. The rates set herein for the Company's water division produce an increase in annual revenues for the water division of 110.63 percent which results in a monthly increase of $23.10, from $19.89 to $42.99, or 116.14 percent, for the average usage (4,740 gallons/month) 3/4-inch meter water customer, and a monthly increase of $22.07, from $19.22 to $41.29, or 114.83 percent, for the median usage (4,500 gallons/month) 3/4-inch meter water customer.

53. According to the Company's application, in the test year ended December 31, 2005, Utility Source's sewer division had adjusted operating income of ($22,959) on an adjusted OCRB of $1,111,382, for a (-2.07) percent rate of return.

54. For its sewer division, Utility Source requests a revenue increase of $139,654, and Staff recommends a revenue increase of $121,549.

55. For purposes of this proceeding, we determine that Utility Source's sewer division has an OCRB and FVRB of $1,113,582.

56. The increase proposed by Utility Source for its sewer division would produce an excessive return on FVRB.

57. For Utility Source's sewer division, a FVROR on FVRB 8.90 percent is reasonable and appropriate.

58. For its sewer division, Utility Source is entitled to a gross revenue increase of $121,549.

59. The rates set herein for the Company's sewer division produce an increase in annual revenues for the sewer division of 106.71 percent which results in a monthly increase of $14.75, from $12.94 to $27.69, or 114.00 percent, for the average usage (4,740 gallons/month) 3/4-inch meter sewer customer, and a monthly increase of $14.00, from $12.29 to $26.29, or 114.00 percent, for the median usage (4,500 gallons/month) 3/4-inch meter sewer customer.

60. Utility Source is not located within any Active Management Area, and consequently is not subject to Arizona Department of Water Resources ("ADWR") reporting and conservation rules.

61. Based on data submitted by the Company, the Arizona Department of Environmental Quality ("ADEQ") has determined that the Company's water system (PWS #03-300) has no deficiencies and is delivering water that meets the water quality standards required by the Arizona Administrative Code.

62. A letter from ADEQ dated March 21, 2006, indicates that the Company's wastewater system is in compliance with ADEQ regulations.

63. The U.S. Environmental Protection Agency ("EPA") has reduced the arsenic maximum contaminant level ("MCL") in drinking water from 50 parts per billion ("ppb") to 10 ppb. The most recent arsenic levels at Utility Source did not exceed 10 ppb for both shallow wells

(blending all five shallow wells at main before tank) and the four deep wells. Based on this arsenic concentration, the Company is in compliance with the new arsenic MCL.

64. Utility Source has no outstanding Commission compliance issues.

65. Staff's recommendation that the Company use the depreciation rates appearing in Tables E1 and E2 of Exhibit JWL (Exh. S-1, Direct Testimony of Jian W. Liu, Exh. JWL at 8-9) is reasonable and should be adopted.

66. Because an allowance for the property tax expense of the Company is included in the Company's rates and will be collected from its customers, the Commission seeks assurances from the Company that any taxes collected from ratepayers have been remitted to the appropriate taxing authority. It has come to the Commission's attention that a number of water companies have been unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers, some for as many as twenty years. It is reasonable, therefore, that as a preventive measure Utility Source annually file, as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

CONCLUSIONS OF LAW

1. Utility Source LLC is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. Sections 40-250 and 40-241.

2. The Commission has jurisdiction over the Company and the subject matter of the application.

3. Notice of the application was provided in the manner prescribed by law.

4. The fair value of Utility Source LLC's water division rate base is $2,753,095, and applying a 6.23 percent fair value rate of return on this fair value rate base produces rates and charges that are just and reasonable.

5. The fair value of Utility Source LLC's sewer division rate base is $1,113,582, and applying an 8.90 percent fair value rate of return on this fair value rate base produces rates and

charges that are just and reasonable.

6. The rates and charges established herein are just and reasonable and in the public interest.

ORDER

IT IS THEREFORE ORDERED that Utility Source, LLC is hereby authorized and directed to file with the Commission, on or before December 31, 2007, the following schedules of revised rates and charges, which shall be effective for all service rendered on and after January 1, 2008:

WATER DIVISION

MONTHLY USAGE CHARGE

5/8" x ¾" Meter	$18.50
¾" Meter	18.50
1" Meter	46.50
1 ½" Meter	92.50
2" Meter	148.00
3" Meter	296.00
4" Meter	462.50
6" Meter	925.00

COMMODITY RATES

5/8" x ¾" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 4,000 Gallons	$4.80
From 4,001 to 9,000 Gallons	7.16
Over 9,000 Gallons	8.60
¾" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 4,000 Gallons	$4.80
From 4,001 to 9,000 Gallons	7.16
Over 9,000 Gallons	8.60
1" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 27,000 Gallons	$7.16
Over 27,000 Gallons	8.60
1 ½ " Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 57,000 Gallons	$7.16

Over 57,000 Gallons	8.60
2" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 94,000 Gallons	$7.16
Over 94,000 Gallons	8.60
3" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 195,000 Gallons	$7.16
Over 195,000 Gallons	8.60
4" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 309,000 Gallons	$7.16
Over 309,000 Gallons	8.60
6" Meter (Residential & Commercial)	
Gallonage Charge per 1,000 Gallons	
From Zero to 615,000 Gallons	$7.16
Over 615,000 Gallons	8.60

Multi-Family Mobile home and Commercial Customers

All consumption per 1,000 gallons:	N/A

Irrigation Meters

Charge per 1,000 gallons for usage:	$9.26

Standpipe or Bulk Water

Charge per 1,000 gallons for usage:	$10.35

Construction Water

Charge per 1,000 gallons for usage:	$10.35

5/8" x ¾" Meter	$520.00
¾" Meter	575.00
1" Meter	660.00
1 ½" Meter	900.00
2" Turbine Meter	1,525.00
2" Compound Meter	2,320.00
3" Turbine Meter	2,275.00
3" Compound Meter	3,110.00
4" Turbine Meter	3,360.00
4" Compound Meter	4,475.00
6" Turbine Meter	6,035.00
6" Compound Meter	8,050.00

SERVICE CHARGES

Establishment of Service	$20.00
Establishment of Service (After Hours)	40.00
Re-establishment of Service	*
Reconnection of Service	50.00
Reconnection (Delinquent and After Hours)	40.00
Charge for moving meter	Cost
After hours service charge	40.00
Minimum Deposit Requirement	**
Deposit Interest	Per Rule
Meter Test	20.00
Meter Re-Read	10.00
Charge for NSF Check	20.00
Late Payment charge for delinquent bill	***
Deferred Payment Finance Charge	***
Main Extension & Additional Facility Agreements	***

* Per Commission rule A.A.C. R-142-403(D).
** Per Commission rule A.A.C. R14-2-403(B).
*** Per Commission rule A.A.C. R14-2-406(B).

SEWER DIVISON

MONTHLY CHARGES

Rate per 1,000 gal. water usage:	
Residential	$5.84
Car washes, Laundromats, commercial, manufacturing	5.71
Hotel and Motels	7.66
Restaurants	9.46
Industrial Laundries	8.39
Waste Haulers	171.20
Restaurant Grease	149.80
Treatment Plant Sludge	171.20
Mud Sump Waste	535.00

SERVICE CHARGES

Establishment of Service	$20.00
Establishment of Service (After Hours)	40.00
Re-establishment of Service	*
Reconnection of Service	50.00
Reconnection (Delinquent and After Hours)	40.00
Minimum Deposit Requirement	**

Deposit Interest	Per Rule
Charges for NSF Check	20.00
Deferred Payment Finance Charge	***
Late Payment, Per Month	***
Service Calls, per hour (After Hours only)	40.00
Service Lateral Connection Charges:	
Residential	500.00
Commercial	Cost
Main Extension Tariff	Cost

* Per Commission rule A.A.C. R-142-603(D).
** Per Commission rule A.A.C. R14-2-603(B).
*** Per Commission rule A.A.C. R14-2-608(F).

IT IS FURTHER ORDERED that Utility Source, LLC shall notify its customers of the revised schedules of rates and charges authorized herein by means of an insert, in a form acceptable to Staff, included in its next regularly scheduled billing.

IT IS FURTHER ORDERED that Utility Source, LLC shall use the depreciation rates set forth in appearing in Tables E1 and E2 of Exhibit JWL to Hearing Exhibit S-1, by individual NARUC category, on a going-forward basis.

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IT IS FURTHER ORDERED that Utility Source, LLC shall annually file as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN		COMMISSIONER
COMMISSIONER	COMMISSIONER	COMMISSIONER

IN WITNESS WHEREOF, I, DEAN S. MILLER, Interim Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this _______ day of _________, 2007.

DEAN S. MILLER
INTERIM EXECUTIVE DIRECTOR

DISSENT ___________________________

DISSENT ___________________________

SERVICE LIST FOR: UTILITY SOURCE, L.L.C.

DOCKET NO.: WS-04235A-06-0303

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